The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: April 2008

Other than the continually surprising presidential primary season, the troubled financial system commanded the attention of the capital, with a new salvo of legislation on housing and credit coming from the Congress as it escalated the "War of Compassion" with the White House as the parties tried to position their opponents as either out-of-touch or wildly loose with the public's money. Initiatives on 401(k) disclosure and responsible use of information from genetic testing seemed to have new life as the entire process seemed to slow in anticipation of the summer, the nominating conventions, and the general election campaign.

Issues and Events

Congress Moves on Housing Relief

Still uncertain whether the White House will countenance additional relief for the troubled housing market, the House of Representatives pressed forward nonetheless on April 23 with several provisions intended to shore up the markets and help troubled borrowers. The legislation is expected on the House floor the week of May 5.

The House Financial Services Committee approved the legislation 38-26, with 3 Republicans crossing party lines to support the bill. One measure aimed at helping States deal with their housing problems provides $15 billion for purchase and rehabilitation of foreclosed properties, with the grant portion of the money ($7.5 billion) able to be applied to taxes and insurance lapsed on the property. Under an amendment from Congresswoman Maxine Waters (D-CA), the money will be distributed based on the State's share of national foreclosures with an adjustment for local housing costs. As is often the case, there is controversy over the formula, which Midwestern State representatives assert unfairly benefits States with inflated housing prices to their detriment. Financial Services Committee Chairman Barney Frank (D-MA) worked out something of a compromise to hopefully generate a more fair distribution of aid by capping the amount any one State could receive but the factions remain dissatisfied and the issue may reappear on the Senate floor.

The same legislation also provides limited legal protection for loan servicers working to restructure mortgages. Elsewhere, the House Veterans Affairs Committee approved a proposal to protect returning veterans from foreclosure for at least a year, raising the limit from the current protection given for 90 days.

Many of the House Committee provisions have counterparts in the Senate companion measure under development by the Senate Banking Committee. Concerns over formula effects on States are particularly difficult for the U.S. Senate to resolve, as that chamber is particularly tied to State concerns. Republican support has been tepid at best, and the Administration is on record as being skeptical about "big government" solutions to the housing crisis.

SEC Credit Rating Agency Report Due This Summer

SEC Chairman Chris Cox told the Senate Banking Committee on April 22 that the Commission's investigative report on credit rating agency practices would be available in early summer. Cox said the thrust of the report would be an inquiry into whether the firms "followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings."

"The credit rating agencies are at the heart of this problem," said Senator Chuck Schumer (D-NY), a senior member of the banking panel, and "The nub of this problem is conflicts of interest." Schumer's sentiments seem fairly widespread among Banking Committee members, many of whom feel they should have known more before the housing and debt market bubble burst.

Particularly to an outside observer, the rating industry would appear rife with such conflicts. The firms are paid not by the buying public but by the selling issuer; the firms often design the very products they then rate for stability and safety; and the firms often have other lucrative consulting dealings with their customers. Advanced reports of the SEC recommendations on the issue so far only mention that such conflicts must be "addressed" and the words "prohibited" or "forbidden" have not yet appeared in this context. The virtual monopoly of three firms – Moody's Investors Service, Standard & Poor's and Fitch Ratings – in the industry is another cause for concern.

Given the prominence of the raters in the financial system, it is unclear whether anything significant will come from the SEC's report. More likely, the report will document poor judgment and lax standards that, as Senator Schumer said, did more than any other actor in the system to create the $1 trillion debt crisis now encroaching on the entire global economy, and that the report will be a starting point for legislation in the next Congress.

Dodd Says Time Running Out On Foreclosures as Credit Trouble Spreads

Senate Banking Committee Chairman Chris Dodd (D-CT) told *The Financial Times* that the clock is ticking and that the government may be almost out of time to do anything meaningful about the housing crisis. "I have got a clock in my own head and that clock runs out in the next several weeks," Dodd said.

While still hopeful that a compromise can be reached, Dodd acknowledged that election year politics weigh against it if there is much further delay and home prices seem likely to erode further while Congress and the President dawdle. "I am optimistic at this point, but this has to happen fairly quickly if it is going to be meaningful," Dodd said.

The Banking Committee heard testimony on April 16 on Dodd's plan for the housing crisis, which would use taxpayer money to underwrite $400 billion in new mortgages and guarantees run through the Federal Housing Administration (FHA). Commenting on a similar – if $100 billion less ambitious – plan by House Financial Services Committee Chairman Barney Frank (D-MA), the nonpartisan Congressional Budget Office (CBO) estimated that taxpayers will lose about $6 billion due to defaults, putting a solid number to what had been amorphous concerns of GOP Members and the White House who want to avoid anything that looks like a taxpayer-financed rescue. Brian Montgomery, a senior Assistant Secretary at the Department of Housing and Urban Development (HUD), said at the hearing that "In the current housing crisis I think we have to draw a line. Some homeowners used poor judgment. A lot of lending companies want a bail-out."

Dodd remains committed to doing more than the Administration seems interested in doing, noting on April 17 that credit pull-backs are starting to affect the student loan market, and he vowed to take steps to defend that area of borrowing. "Just this week, two major banks announced that they will be scaling back their student loan businesses as a result of the turmoil in our credit markets," he said in a statement. "The Treasury Department and the Federal Reserve Board must be prepared to take immediate, decisive action to prevent today's concern from worsening into tomorrow's crisis."

The Bush Administration opposes both Congressional plans, although the word "veto" has not yet been said by the President or his agents. Dodd noted that he had received "mixed messages" from the Administration. An approach that does seem to have bipartisan support involves offering incentives to lenders to write-down the amounts owed and to refinance troubled loans; the Administration has concentrated on using the government only as a middleman or broker for the private sector to work out the problems in the system. A possible compromise could come through Congressional approval of an Administration wish to make changes to Fannie Mae and Freddie Mac, where critics are concerned about the implicit taxpayer guarantees in these organizations.

It remains to be seen whether public concern will bring action on the housing markets. A March Gallup poll conducted in late March found 56% of the public favors government intervention and 42% oppose it, suggesting that the voters have still not committed to a course of action. Lenders may also drive Congressional action for relief, and could swallow the write-down proposal if there is no public pressure for a more broad-based relief program. At the moment, the two parties seem too far apart for the legislation to survive the process but events could change the current balance of interests to favor some compromise action by Washington.

Treasury Says Hedge Funds Need More Oversight

Two committees including pension and hedge fund members operating under the auspices of the U.S. Treasury Department released a report concluding that the hedge fund industry needs tighter control. One committee was charged with developing a list of best practices for the hedge fund industry while the other worked on hedge fund issues from the investor side. The proposals for improvement do not include Federal oversight of hedge funds. Instead, funds would voluntarily create independent units to oversee how esoteric assets are being priced by the operations side of the house.

CalPERS' Russell Read chaired the second committee, which completed work on creating a guide for investors about where and whether to invest in hedge funds. Read concurred with the decision to leave the government out of hedge fund regulation at this point and said that the committee's work would promote "healthier hedge funds, healthier investment practices in those funds, and for a healthier impact of hedge funds on the capital markets in general."

Complex derivatives and other cryptic, less liquid, and hard to price securities drew special attention from the groups. Such attention seems merited, given the prominent part that such securities played in the credit meltdown currently bedeviling the markets and the guesswork by hedge funds and other experts involved in valuing these assets. Treasury Secretary Hank Paulson said of the findings, “Today's release reinforces our belief that a combination of robust market discipline and regulatory policies best protect investors and mitigate systemic risk.”

Hedge funds in general do not appear to have lost their appetite for risk. Several large funds recently announced their intention to go bottom-fishing for mispriced securities dumped by panic-struck investors. Such bargain hunting now illustrates the value of these funds in providing liquidity, even if a substantial share of the current credit problem arose from other funds that took overly aggressive positions. It does appear that some funds have lost their taste for leverage, with Shoaib Khan of UBP telling reporters that, “While the basket of bank loans trading at stressed and distressed levels may not be attractive, there are situations within the basket that are attractive. It is our intention to capture these select opportunities trading at cheap valuations, but have good collateral and covenants in order to provide downside protection.”

There will likely be additional interest, or outrage, concerning hedge funds as the latest round of earnings was announced, with annual incomes for fund manager John Paulson at $3.7 billion, George Soros at $2.9 billion, and James Simons at $2.8 billion; In 2002, the top 25 hedge fund managers had a *combined* income of $2.8 billion. Last year, many in Congress sought to change the current pay practices for fund managers, which results in them being taxed at the capital gains rate of 15% rather than the earned income rate of 36%. The proposal was defeated by industry lobbying, and most investor groups took no position on the issue.

Opponents Rail Against 401(k) Fee Legislation

Critics of H.R. 3185, a bill to force certain disclosures of 401(k) fees, wrote to House Education and Labor Committee Chairman George Miller (D-CA) on April 15 to reiterate their problems with the bill. Fees in 401(k) plans became an issue after a House hearing and a study by the Government Accountability Office (GAO) demonstrating how fees eat into returns over time.

The legislation is an ERISA amendment that requires administrators above a $1,000 threshold to spell out details of who will provide the services, what the services are, and give an estimate of the costs of the services. The bill mandates that administrators provide an annual statement of investment options, a cost schedule, and a benefit balance and also requires that the administrator provide “at least one nationally recognized market-based index fund,” although this provision was dropped during floor consideration. Under the proposal, the Labor Department will develop a model statement for use as well as educational and informative materials and supporting information for selecting a vendor.

While agreeing that disclosure is a good thing, the group of 401(k) vendor interests took issue with the “unbundling” of fees, where the legislation may require firms to price services separately even if they are not offered separately, i.e., a kind of “component” pricing that the groups claim have no value to clients. The firms argued that having a simple total cost listed serves the purpose of the legislation. The letter also questioned the need for offering the choice of a widely-used index and described the commission disclosure language as “unnecessary” and asserted that the competitive industry already has incentives to keep fees down.

The Education and Labor Committee passed the bill 25-19 on April 16, dropping the index fund requirement. Chairman Miller said of the bill “For too long, companies in the financial services industry have maintained a stranglehold on retirement savings that they didn't earn and that don't belong to them. Workers are entitled to clear and complete information about their own savings.” Ranking Republican Buck McKeon (R-CA) countered that “This bill may focus more on information quantity than quality. If that is the case, we may be doing more harm than good by overwhelming workers with cumbersome or incomprehensible information.”

While a similar bill (S.2473) is pending in the Senate, there has been no action there and that body may be less willing to press the issue given fairly unified Republican opposition.

Doomed Regulatory Reform Plan Swarmed by Foes

Moments after Treasury Secretary Hank Paulson unveiled a proposal to reform the financial regulatory system, foes of change began their campaign against it.

Even in the best circumstances, the plan to reorganize the network of regulators would face a difficult time; from an Administration in its last months facing a Congress held by the opposing party, the campaign against portions of the plan are meant to “kill it so dead” that it does not arise in a future Administration with a stronger hand. Opponents not only include the interest groups who have comfortable, or at least predictable, relationships with their overseers but also less overt opposition from inside the Executive Branch.

The Treasury group proposes eventual regulatory consolidation, a new mortgage regulator to oversee standards for brokers, new powers for the Federal Reserve to oversee all institutions in the lending business for risk, a single regulator for financial solvency, merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), and a national charter that would void State regulation for insurers.

Congressional reaction to the plan was generally negative. “Since this is opening day in baseball, I might as well make a baseball metaphor. This is a wild pitch. It is not even close to the strike zone,” said Senate Banking Committee Chairman Chris Dodd (D-CT) in a widely cited quote. He also said of the Treasury plan that “On the one hand, it would allow the Fed to examine all financial companies — not just banks — to be sure they are not posing a risk to the overall financial system. On the other hand, it fails to realize that the Fed helped create this crisis by ignoring the red flags as far back as five years ago. It does not make sense to give a bigger shovel to the very people who helped dig us into this hole.” Senate Majority Leader Harry Reid (D-NV) said that helping borrowers, not regulatory reform, topped his list of financially-oriented legislation.

Paulson said that the plan is not simply about more or less regulation. “The blueprint is about structure and responsibilities — not the regulations each entity would write. The benefit of the structure we outline is the accountability that stems from having one agency responsible for each regulatory objective. Few, if any, will defend our current Balkanized system as optimal,” Paulson said.

But that does not mean that the public was ecstatic about the proposed replacement. While spokesmen for the thrift industry and credit unions objected to provisions that could essentially end their existence as anything other than a bank with a different name, other resistance came from inside the Administration. Sheila Blair, Chairman of the Federal Deposit Insurance Corporation (FDIC), said of the plan "The FDIC has been a highly successful model for 75 years. During this time, no one has lost a single penny of insured deposits and public confidence in our banking system has remained high. Any long-term structural changes to the financial regulatory framework must be carefully weighed against the FDIC's strong record and the fact that it serves as a model for developing countries around the world." The Paulson plan would end FDIC's supervision of State banks; FDIC, like other bank regulators, would be folded into a new agency.

The Treasury blueprint also includes merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), an initiative that has splintered on the rocks of Congressional Committee turf each time it has been proposed. A new addition to the argument against a merger is that the plan is justified by allowing faster innovation and innovation is part of what has caused the subprime disaster; the web of securitization continues to complicate efforts to help borrowers and created the independent brokers and other players in the market with no long-term interest in the performance of the loan.

Here again, the agency itself expressed opposition to the proposal including it. "What I don't hear is a call from the countryside for moving boxes around in Washington, D.C., or the need for some omnipresent super-regulator," said CFTC Commissioner Bart Chilton.

With a plan unsold even to its internal constituent parts, the Paulson plan seems destined to be yet another report to grace the bookshelves of financial lobbyists for the next decade. The electoral season also argues against major initiatives that shift precious turf from agency to agency.

CalPERS Testifies as Senate Banking Committee Looks at Sovereign Wealth Funds

The Senate Banking Committee held a hearing April 24 to examine the expanding role of sovereign wealth funds, the lightly regulated investment funds operated by sovereign governments. The Securities and Exchange Commission and the Federal Reserve oversee these funds, and the Treasury Department released new regulations on April 21 to implement the Foreign Investment and National Security Act (FINSA), passed last July, that adds additional requirements for these investment vehicles. CalPERS' Dennis Johnson, Senior Portfolio Manager for Corporate Governance, testified for the Board and System at the hearing.

Chairman Christopher Dodd (D-CT) expressed the public policy interest of the Committee in balancing the need to attract capital with the desire to protect national security. A substantial amount of investment has come from the funds of only four countries – the United Arab Emirates, Kuwait, Singapore, and China – placing their large foreign exchange or petrodollar reserves. Biden said that sovereign wealth funds control about $2-3 trillion globally. As Dodd said in a statement, "With that kind of rapidly growing financial muscle, the operations of sovereign wealth funds in the U.S. markets have raised questions generally about how they are run, by whom, and for what purpose."

The Dodd statement continued: “This Committee – and the American Public – must know with certainty that sovereign wealth funds conduct themselves according to the same standards to which other economic actors are held: transparency, sound governance, commercial purpose, and market integrity.”

CalPERS’ testimony stressed that the System was able to function at high levels with numerous layers of disclosure and transparency, anticipating a complaint from the funds heard by the Committee about the negative effects of more regulation. Under several Federal and State laws, and the policies of the Board itself, CalPERS has copious requirements to disclose its investments, returns, policies, governance actions, and other operational details of the plan. In addition, Johnson noted that meetings of the Board are open, with agendas posted in advance and every Board member available and accountable to the public.

The regulations from Treasury tinker with the rules about when sovereign wealth funds can expect scrutiny from the Federal government. Several in Congress remain unsatisfied with the regulations and plan future legislation. At the Senate Banking hearing, Senator Evan Bayh (D-IN) characterized several of the triggers in the regulations as “arbitrary” and may offer a bill this summer to close “loopholes.”

California Congressional Delegation

During the month, California Congressman George Miller, Chairman of the House Education and Labor Committee, brought a complex and contentious 401(k) disclosure bill through his panel, where it now awaits scheduling for the House floor. While some remain unhappy with the legislation and the controversial provision to mandate inclusion of a commonly-known index fund in the choices available for 401(k) participants remains up in the air, the bill (H.R. 3185) addresses a serious problem uncovered by the Government Accountability Office (GAO) last year. That inquiry examined how even a seemingly small difference in fees can lead to drastically different returns over the lifespan of a 401(k) account. The Miller legislation meets the problem head on and, if not perfect, is still a needed improvement to the current disclosure rules for deferred comp plans.

Related National and Industry News

Connecticut May Offer Universal 401(k)

The State of Connecticut is considering offering a 401(k) to any worker within the State in order to boost retirement savings, improve coverage at small businesses, and cut fees. S.B. 262 would make the State comptroller’s office the administrative unit for a 401(k) program offered to the State’s private employees; State workers already have access to 401(a), 401(k), 457, and 403(b) retirement savings plans. The new funds will be funded through administrative fees charged to the account, which will repay the General Fund for start-up costs.

State Senate Pro Tempore Donald Williams said in a statement that “Our proposal will help people save for retirement and instantly give our small businesses a real advantage over out-of-state competitors. The fees associated with 401(k) plans have a disproportionate impact on people who work for small businesses. The result is that the majority of these employees don't have 401(k) plans, and at the same time, the small businesses are at a competitive disadvantage when it comes to recruiting workers. We're ready to take on the special interests and fight for working families and small businesses here in Connecticut."

Economic Doldrums Torpedoes Retirement Confidence

A report from the Employee Benefit Research Institute (EBRI) finds workers more pessimistic about their retirement prospects. EBRI recorded confidence in worker prospects for a secure retirement at the lowest level in seven years, likely propelled by dropping home prices and economic concerns, which cause employees to "feel poor," and rising health costs, which actually make them poor. Those reporting high levels of confidence dropped off the most sharply, scoring the largest drop in 18 years.

Health costs continue to drag down workers and retirees. Many retirees (44%) say they spend more than expected on health care in retirement and 54% are more pessimistic about their future than they were immediately after retirement, up 14% from one year ago. A third (34%) of workers expect their employer to continue coverage in retirement, a dimming prospect based on current trends, where 41% of retirees have such coverage and employers continue to cancel this expensive obligation to ex-workers.

In a bit of good news, more workers are planning for retirement (47%) than a year ago (42%) and, EBRI notes, well up from the dismal 29% of 1996. Past measures have found even simple calculation of the amount needed for retirement to change savings behavior about half (44%) of the time. Still, EBRI charitably describes the typical savings level as "modest," with 49% of respondents saying they have less than $50,000 banked for retirement and 22% reporting no savings "of any kind." Part of the reason stems from the low priority of retirement savings amid the financial demands on employees. A paltry 5% mentioned retirement savings as a "pressing financial issue," well after making ends meet (17%), paying for healthcare (16%), meeting housing costs (16%), or paying down debt (13%).

"In the nearly two decades we have been conducting the [survey], this year's results show a very dramatic reduction in the public's confidence about having a comfortable retirement. The economy and health costs are major concerns," said EBRI President Dallas Salisbury. "If there is a silver lining, it's that Americans finally may be waking up to the realities of being able to afford retirement."

Economic downturns have traditionally rippled through the retirement community. Emergency loans from pension plans rise to forestall personal financial disaster; Congress always toys with the idea of penalty-free withdrawals from plans to boost the flow of money in the economy; and most workers are counting on the value of their homes – now battered by the subprime crisis and linked to the word "bubble" with troubling regularity – for the bulk of their retirement money. Many of these moves feel good today but compromise retirement savings in the long run, and this downturn may likely follow previous ones in its effects on the plan community.

Accountant Big Wigs Pronounce System "Irretrievably Broken"

Representatives of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) agreed that the present unpleasantness in the financial system has revealed that the current rules intended to capture risk are "irretrievably broken." So read a report from Jim Liesenring of the IASB board and Tom Linsmeier of the FASB board, who were joined by Sue Bielstein and Wayne Upton, senior technical directors on each body; the report is not the official position of either group.

The report's authors do not see a solution in the near term. "Completing a final standard by mid-2011 will be extremely difficult, perhaps impossible," says the report. The sticky topic of off-balance sheet assets will require time to address, despite the urgency created by the current collapse of mortgage-backed securities. The International Monetary Fund (IMF)'s *World Economic Outlook* report released on April 9 estimated the global effect at $565 billion in mortgage delinquencies and $945 billion counting other loans and securities tied to commercial real estate, consumer credit, and corporations involved in this paper. "The events of the past six months have demonstrated the fragility of the global financial system and raised fundamental questions about the effectiveness of the response by private and public sector institutions," the IMF said.

Although accounting "standard setters" feel the urgency of the need for new rules to assure governments and investors, the Liesenring *et al* report asserts that reform efforts have foundered due to staff turnover, the "relative inexperience" of those working on the project, and the lack of a senior leader for the project to give it skill and bureaucratic heft, saying that "We cannot afford the luxury of waiting for the newly assigned staff to get up to speed."